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Nigeria Power Series - Part 2: Unlocking Financing for Developing Independent Power Projects in Nigeria

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Unlocking Financing for Developing Independent Power Projects in Nigeria

1. Introduction:

The Dentons Nigeria Power Series comprises briefing notes on the Nigerian power sector. In this second instalment, we will consider some key consideration for unlocking debt finance for funding the development and operation of independent power projects (**IPPs**) in Nigeria and provide an overview of some regulatory reform and policies that, if implemented, will help to stabilise and attract much-needed investment into the Nigerian power sector.

2. Lenders' bankability assessment and risk allocation

The majority of an IPP's capital costs will be financed by the commercial banks and development financial institutions that typically finance power projects (the **Lenders**) (alongside a smaller portion of equity funding provided by the developers of the IPP (the **IPP Developers**)). Consequently, satisfaction of the Lenders' bankability requirements will be a critical precondition to funding the IPP on a limited-recourse or non-recourse basis and therefore a key consideration for the IPP Developers. Reference to "Lenders' bankability requirement" means the Lenders' expectation that material project risks relating to the IPP have been assessed and allocated satisfactorily to a project counterparty that is able to bear such a risk or, if retained by the IPP, is mitigated to the satisfaction of the Lenders.

The bankability assessment will be largely project-specific and will take into account a number of additional factors, such as the prevailing market practice in the relevant debt market, the nature and location of the IPP, the host country and the identity of the project participants. It is, however, typical for Lenders to expect the IPP Developer to have mitigated the following risks through the project documents and other ancillary commercial arrangements:

a. Mitigating fuel supply and/or transportation risk

The IPP's ability to generate sufficient revenue from the sale of power to cover its costs and repay its debt will depend upon its access to a secure source of feedstock gas delivered to the IPP. Accordingly, the Lenders (and their transactional advisers) will need to be satisfied that:

(a) the corporate entity incorporated to own the project assets and enter into project documents (the **Project Company**) will enter into a long-term gas supply agreement (a **Gas Supply Agreement**) with a creditworthy gas supplier (the **Gas Supplier**), which is typically an upstream producer, or indirectly through the Gas Aggregation Company of Nigeria;

(b) the Gas Supply Agreement includes a firm feedstock gas throughput obligation to underpin the Project Company's ability to generate sufficient power to discharge its power generation delivery obligation to Nigerian Bulk Electricity Trading Plc (**NBET**) under the power purchase agreement entered into between the Project Company and NBET (the **PPA**); and

(c) the Project Company has entered into a satisfactory gas transportation arrangement that provides sufficient pipeline capacity and/or adequate contractual protection (e.g., through business interruption insurance) against the heightened risk of disruption to gas supply, for example, resulting from frequent sabotage of onshore oil and gas pipelines and associated infrastructure in the Niger Delta region[1].

[1] Additional fuel supply risk mitigants include: (a) for the Project Company to secure alternative fuel supply arrangements on a contingency basis; or (b) for the IPP to be developed to have dual fuel capabilities - for example, a power plant that is capable of using biofuel, diesel or heavy fuel oil for power generation in the event that gas feedstock is temporarily unavailable.

In return, the Gas Supplier is likely to expect the Project Company to provide credit support to back-stop its payment obligations under the Gas Supply Agreement. This credit support may be provided in different forms, including a parent company guarantee from an IPP Developer or through a letter of credit (an **LC**), which may be structured as part of the financing to be provided by the Lenders (e.g., through an LC facility).

b. Mitigating the EPC Contractor's payment and/or performance risk

The IPP will not become operational or capable of generating revenue until it has been constructed and successfully commissioned for power generation. Consequently, the Lenders (and their transactional advisers) will expect:

(a) the Project Company to enter into a turnkey engineering, procurement and construction contract (the **EPC Contract**) with a creditworthy, experienced and technically capable contractor (the **EPC Contractor**);

(b) the EPC Contract to include incentives and penalties (as applicable) to ensure that the construction of the IPP is completed on schedule, within budget and in line with a pre-agreed set of specifications;[2]

(c) the EPC Contractor to be under an obligation to pay liquidated damages for delays to the construction timetable or the power plant's failure to achieve a pre-agreed level of electricity output;[3]

(d) the EPC Contract to include explicit controls over assignment, transfer and/or subcontracting of the EPC Contractor's obligations, e.g., by making the completion of any of these processes subject to (i) the Project Company's prior approval or (ii) the assignee, transferee or subcontractor satisfying minimum financial, reputational and technical requirements; and

(e) the EPC Contractor to provide an acceptable form of credit enhancement in favour of the Project Company to back-stop its payment or performance obligations (including a parent company guarantee, a performance bond or an LC), particularly where the EPC Contractor does not have a credit rating.

c. Mitigating the Operator’s payment and/or performance risk

Effective and uninterrupted operation of the IPP is clearly an essential precondition to the Project Company producing the power required to be sold to NBET under the PPA and for generating the revenues required to fund operating costs and debt service.

Accordingly, the Lenders (and their transactional advisers) will expect:

(a) the Project Company to have entered into a long-term operation and maintenance contract (the **O&M Contract**) with a creditworthy, experienced and technically capable operator (the **Operator**), which might be an affiliate of the Project Company or a third party;

(b) the Operator to be under an obligation to run the IPP based on pre-agreed key performance indicators that are in line with industry standards of performance for maximising the processing capability of the IPP;

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[2] This will enable the IPP to satisfactorily complete the commissioning testing with minimal snagging requirements.

[3] The Lenders will also expect any overall cap on the EPC Contractor's liabilities to be at a satisfactory level.

(c) an approved strategy and budget for procurement of spare parts and effecting scheduled maintenance, which is reflected in the financial model, the project accounts structure and finance documents;

(d) the scope of operation and maintenance services, fees and any applicable limitation of the Operator's liability to be in line with current market standards; and

(e) there to be explicit controls over assignment, transfer and/or subcontracting of the Operator’s obligations, for example, by making the completion of any of these processes subject to (i) the Project Company's prior approval or (ii) the assignee, transferee or subcontractor satisfying minimum financial, reputational and technical requirements.

d. Mitigating NBET's payment and/or performance risk

The PPA is the main source of revenue from which the Project Company will discharge its debt service obligations to the Lenders and payment obligations to the Gas Supplier under the Gas Supply Agreement. The scope of NBET's credit risk as offtaker under PPAs is exacerbated given that (i) it is a special purpose vehicle with limited trading history and (ii) it is directly exposed to the credit and performance risk of power distribution companies (in their capacity as power purchasers under vesting contracts). Lenders will therefore view the stability and predictability of the revenue stream under the PPA and credit enhancement of NBET as critical to the project's bankability assessment.

In particular, the Lenders (and their transactional advisers) will expect the PPA to satisfy the following requirements:

(a) the term of the PPA must exceed the tenor of the debt facility provided by the Lenders;

(b) the PPA should provide a robust tariff structure that includes payment of capacity charges for dependable capacity and energy charges for electrical energy delivered, with the capacity component being sized to cover scheduled debt service;

(c) NBET must be sufficiently capitalised[4] and its payment obligations[5] back-stopped through acceptable forms of credit enhancement products, such as:

  (i) the provision of bank guarantees or letters of credit from acceptable financial institutions which may be back-stopped by a partial risk guarantee;[6]

  (ii) letters of support from the federal government of Nigeria (the **Nigerian Government**);[7]

  (iii) guarantees from the Nigerian Government in order to maximise the credit rating of any debt instruments issued by NBET;

[4] A funding option might be for NBET to issue debt instruments to institutional investors in the Nigerian capital markets.

[5] For example, in the event that NBET exercises its early termination rights under the PPA, which is likely to trigger NBET's compensation obligations in favour of the Project Company.

[6] For example, provided by the Nigerian Government or a multilateral financial institution, such as The World Bank or the African Development Bank.

[7] Depending on the precise drafting, a letter of support from the Nigerian Government might be construed as giving soft comfort to the Project Company in respect of the IPP, which may be insufficient to give rise to binding obligations on the Nigerian Government.

(iv) cash escrow accounts;[8] and/or

(v) a put and call option agreement which enables the IPP Developer to sell the IPP (or its shares in the Project Company) to the Nigerian Government at a predetermined price, which will be sufficient to cover the outstanding debt;[9]

(d) given the transitional nature of NBET,[10] there is a need for PPAs to address the process, risk exposure and protection related to NBET's transfer of its rights and obligations under PPAs to a distribution company, particularly where such a transfer results in a termination of any credit enhancement provided by the Nigerian Government in relation to NBET's obligations under the PPA; and

(e) the scope of the "force majeure" provisions in the PPA will need to be consistent with the scope of the "force majeure" provisions across the suite of project documents, particularly the Gas Supply Agreement, EPC Contract and O&M Contact.

e. Mitigating project interface risk

Risks related to the transition of the project from the construction phase to the operation phase can be exacerbated if (as is often the case) the EPC Contractor is a separate entity from the Operator. It will be important to ensure that the works completed under the EPC Contract are acceptable to the Operator through its participation in the commissioning tests, thereby avoiding claims by the Operator that the IPP is incapable of proper performance or requires remedial works.

Separately, the commissioning process under the EPC Contract will need to be harmonised with the provisions of the PPA and O&M Agreement in order to ensure that there is a back-to-back position across the suite of project documents. Similarly, a delay to the commissioning of the IPP that results in payment of delay liquidated damages under the PPA should give rise to a corresponding payment of delay-related liquidated damages under the EPC Contract.

Lastly, the IPP Developers will need to identify the Project Company's counterparty (a **Project Party**) that is responsible for delivering any associated infrastructure or concluding arrangements for connecting the power plant to gas supply infrastructure and/or the grid network for power evacuation. In any event, the associated infrastructure and contractual arrangements will need to have been put in place before the IPP is commissioned to ensure that there are no delays to the commencement of the IPP's operational (revenue-generating) phase.

[8] The use of cash as a credit enhancement tool is likely to be a more expensive option from NBET's perspective given the prevailing liquidity constraint in the Nigerian power sector and the negative cost of carry associated with depositing cash in an escrow account.

[9] We understand that, on the Azura-Edo IPP financing, the project company mitigated the risk of NBET's termination of the PPA by obtaining a "put and call option" from NBET and the Nigerian Ministry of Finance. Azura Report titled: "High Voltage – A Development Guide to the 459MW Azura-Edo IPP".

[10] The Electric Power Sector Reform Act 2005 anticipates that NBET will fulfil its intermediary bulk trading role (comprising (i) purchase of power from power producers under PPAs and (ii) resale of power to distribution companies under vesting contracts) until the power distribution companies have satisfactorily demonstrated their commercial viability (e.g., improving revenue collection and increasing operational efficiency) to purchase power directly from the power producers to the Minister of Power.

f. Mitigating currency risk

It is typical for the majority of loan facilities for IPPs to be denominated in a foreign currency (typically, US Dollars) to reflect the currency of material project costs (particularly under the EPC Contract) and given the short tenor available and high cost of obtaining Naira-denominated facilities. A significant number of PPAs are structured on the basis that payments due from NBET to the power producer are denominated in Nigerian Naira.[11] The use of Naira-denominated revenues to service a foreign currency-denominated loan facility clearly gives rise to a currency mismatch and several associated risks. These risks include (i) restrictions on convertibility of Nigerian Naira to a foreign currency, (ii) limitations on transfer of foreign currency out of Nigeria and (iii) devaluation of the Nigerian Naira against a foreign currency.

In order to mitigate repatriation risk, the Project Company will need to obtain a certificate of importation, which serves as documentary evidence that the Project Company has brought foreign currency into Nigeria (through debt, equity or otherwise) for the purpose of developing, financing or operating the IPP and permits the Project Company to repatriate revenues from the IPP towards debt service in favour of the Lenders and/or distributions to the IPP Developers.

In addition, the Project Company may mitigate currency risk by obtaining currency hedging products or political risk insurance or utilising offshore collection accounts.

g. Mitigating Project Party's performance risk

In addition to Lenders receiving assurance of the financial standing, experience and technical capability of the Project Party, the Lenders will typically expect to be granted a direct contractual relationship with the Project Party through their entry into a direct agreement with the Project Company and the relevant Project Party (a **Direct Agreement**).

During negotiations of a project document between the Project Company and a Project Party (even where financing is not yet contemplated), it is recommended that the project document (i) includes a form of the Direct Agreement to be entered into between the Project Company, the relevant Project Party and the Lenders or (ii) recognises that the Project Company, the relevant Project Party and the Lenders will enter into a Direct Agreement.

h. Marshalling project revenue

Given the limited recourse nature of project financing structures, the Lenders may seek to regulate the collection and use of the IPP's revenues in order to ensure full and regular debt service payments as follows:

(a) through the use of several designated accounts (which may include (i) revenue accounts, (ii) operating accounts, (iii) debt service accounts, (iv) debt service and maintenance reserve accounts and (v) distribution accounts, together the **Project Accounts**) that are secured in favour of the Lenders;

[11] We have seen instances where there is an additional mechanism providing for indexation of Nigerian Naira-denominated receivables to US Dollars.

(b) by including a cashflow waterfall in the finance documents[12] that stipulates a synchronised order of priority for permitted withdrawals from the Project Accounts (typically, allowing payment of operating expenses, followed by debt service, topping up debt service and maintenance and reserve accounts before permitting distributions to the IPP Developers, subject to the satisfaction of any required distribution controls);

(c) imposing covenants on the Project Company only to make withdrawals from the Project Accounts in line with the cashflow waterfall;

(d) through the use of a sculpted amortisation profile that accommodates the ramp-up phase for the operation of an IPP where the project might not generate sufficient revenue to guarantee full debt service; and

(e) including a cash sweep mechanism which requires the Project Company to use excess free cash flows to prepay outstanding debt in order to shorting the tenor of the facility, instead of permitting a distribution to the IPP Developers.

3. Conclusion – outlook for 2017 and beyond

The successful closing of the financing for the Azura-Edo IPP demonstrates that, under the right circumstances, well-structured IPPs in Nigeria will be able to source a combination of international and domestic financing and achieve financial close. In order to achieve these objectives, it is imperative that (a) IPP Developers and Lenders remain committed to finding innovative solutions to the commercial, fiscal and legal challenges that may arise on the path the developing and financing IPPs, and (b) the Nigerian Government continues to demonstrate the political will to provide a suitable political, fiscal and regulatory environment that attracts and increases the level of private sector participation and investment in Nigeria's power sector.

It has been reported that the Nigerian Government is currently in consultation with stakeholders[13] in respect of the proposed issuance of green bonds[14] in Nigeria in 2017. These green bonds will be used to fund a pipeline of eligible renewable energy projects in Nigeria, which will (a) facilitate the Nigerian Government's implementation of the Paris agreement on climate change and (b) provide additional liquidity into the Nigerian power sector by expanding the funding sources for power projects to attract investment from pension funds, asset managers and other institutional investors.

[12] For example, including account provisions in the facility agreement or entering into a stand-alone accounts agreement.

[13] Stakeholders include: the Ministry of Environment; the Ministry of Finance; the Ministry of Budget and National Planning; the Ministry of Trade and Investment; the Nigerian Stock Exchange; the Debt Management Office; the CBN; the Securities and Exchange Commission; several financial institutions and other private sector representatives.

[14] Green bonds are a specific sub-set of bond instruments, the proceeds of which are used to finance the construction and operation of renewable energy projects that satisfy energy efficiency and environmental benefit parameters.

This briefing note is provided for information purposes only and does not constitute legal advice. For further information on the content of this briefing note or legal advice, please contact **Dominic Spacie** or **Omosuyi Fred-Omojole**.

You might also be interested in the first instalment of the Dentons Nigeria Power Series briefing notes (titled: "**Developing Bankable Independent Power Projects in Nigeria**"), which was launched in November 2016.

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